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Privately financed infrastructure projects: draft chapters of a legislative guide on privately financed infrastructure projects

Report of the Secretary-General

Addendum

Chapter V. Duration, extension and termination of the project agreement

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Legislative recommendations

For host countries wishing to promote privately financed infrastructure projects it is recommended that the following principles should be implemented by the law:

Duration and extension of the project agreement (see paras. 2-8)

Recommendation 60. The duration of the concession should be specified in the project agreement.

Recommendation 61. The term of the concession should not be extended, except in those circumstances specified in the law, such as:

(a) Completion delay or interruption of operation due to the occurrence of circumstances beyond either party's reasonable control;

(b) Project suspension brought about by acts of the contracting authority or other public authorities;

(c) To allow the concessionaire to recover additional costs arising from requirements of the contracting authority not originally foreseen in the project agreement that the concessionaire would not be able to recover during the normal term of the project agreement.

Termination of the project agreement (see paras. 9-35)

Termination by the contracting authority

Recommendation 62. The contracting authority should have the right to terminate the project agreement:

(a) In the event that it can no longer be reasonably expected that the concessionaire will be able or willing to perform its obligations, owing to insolvency, serious breach or otherwise;

(b) For reasons of public interest, subject to payment of compensation to the concessionaire.

Termination by the concessionaire

Recommendation 63. The concessionaire should have the right to terminate the project agreement under exceptional circumstances specified in the law, such as:

(a) In the event of serious breach by the contracting authority or other public authority as regards the fulfilment of their obligations under the project agreement;

(b) In the event that the concessionaire's performance is rendered substantially more onerous as a result of variation orders or other acts of the contracting authority, unforeseen changes in conditions or acts of other public authorities and that the parties have failed to agree on an appropriate revision of the project agreement.

Termination by either party

Recommendation 64. Either party should have the right to terminate the project agreement in the event that the performance of its obligations is rendered impossible by

the occurrence of circumstances beyond either party's reasonable control. The parties should also have the right to terminate the project agreement by mutual consent.

Consequences of expiry or termination of the project agreement (see paras. 36-62)

Transfer of assets to the contracting authority or to a new concessionaire

Recommendation 65. The project agreement should lay down the criteria for establishing, as appropriate, the compensation to which the concessionaire may be entitled in respect of assets transferred to the contracting authority or to a new concessionaire or purchased by the contracting authority upon expiry or termination of the project agreement.

Financial arrangements upon termination

Recommendation 66. The project agreement should stipulate how compensation due to either party in the event of termination of the project agreement is to be calculated, providing, where appropriate, for compensation for the fair value of works performed under the project agreement and for losses, including lost profits.

Wind-up and transfer measures

Recommendation 67. The project agreement should set out, as appropriate, the rights and obligations of the parties with respect to:

(a) The transfer of technology required for the operation of the facility;

(b) The training of the contracting authority's personnel or of a successor concessionaire in the operation and maintenance of the facility;

(c) The provision, by the concessionaire, of operation and maintenance services and the supply of spare parts, if required, for a reasonable period after the transfer of the facility to the contracting authority or to a successor concessionaire.

Notes on the legislative recommendations

A. General remarks

1. Most privately financed infrastructure projects are undertaken for a certain period, at the end of which the concessionaire transfers to the contracting authority the responsibility for the operation of the infrastructure facility. Section B deals with elements to be taken into account when establishing the concession period. Section C deals with the question of whether and under what circumstances the project agreement may be extended. Section D considers circumstances that may authorize the termination of the project agreement prior to the expiry of its term. Lastly, section E deals with the consequences of the expiry or termination of the project agreement, including the transfer of project assets and the compensation to which either party may be entitled upon termination, and the wind-up of the project.

B. Duration of the project agreement

2. The laws of some countries contain provisions that limit the duration of infrastructure concessions to a certain number of years. Some laws establish a general limit for most infrastructure projects and special limits for projects in particular infrastructure sectors. In some countries there are maximum duration periods only for certain infrastructure sectors.

3. The desirable duration of a project agreement may depend on a number of factors, such as the operational life of the facility; the period during which the service is likely to be required; the expected useful life of the assets associated with the project; how changeable the technology required for the project is; and the time needed for the concessionaire to repay its debts and amortize the initial investment. The notion of economic "amortization", in this context, refers to the gradual charging of the investment made against project revenue on the assumption that the facility would have no residual value at the end of the project term. Given the difficulty of establishing a single statutory limit for the duration of infrastructure projects, it is advisable to provide the contracting authority with some flexibility to negotiate, in each case, a term that is appropriate to the project in question.

4. In some legal systems, this result is achieved by provisions that require that all concessions should be subject to a maximum duration period, without specifying any number of years. Sometimes the law only indicates which elements are to be taken into account for determining the duration of the concession, which may include the nature and amount of investment required to be made by the concessionaire and the normal amortization period for the particular facilities and installations concerned. Some project- or sector-specific laws provide for a combined system requiring that the project agreement should provide for the expiry of the concession at the end of a certain period or once the debts of the concessionaire have been fully repaid and a certain revenue, production or usage level has been achieved, whichever is the earliest.

5. However, where it is found necessary to adopt statutory limits, the maximum period should be sufficiently long to allow the concessionaire to repay its debts fully and to achieve a reasonable profit. Furthermore, it may be useful to authorize the contracting authority, in exceptional cases, to agree to longer concession periods, taking into account the amount of the investment and the required recovering period, and subject to special approval procedures.

C. Extension of the project agreement

6. In the contracting practice of some countries, the contracting authority and the concessionaire may agree on one or more extensions of the concession period. More often, however, domestic laws only authorize an extension of the project agreement under exceptional circumstances. In this case, upon expiry of the project agreement the contracting authority is normally required to select a new concessionaire, normally using the same procedures applied to select the concessionaire whose concession has expired (for a discussion of selection procedures, see chap. III, "Selection of the concessionaire").

7. A number of countries have found it useful to require that exclusive concessions be rebid from time to time rather than freely extended by the parties. Periodic rebidding may give the concessionaire strong performance incentives. The period between the initial award and the first (and subsequent) rebidding should take into account the level of investment and other risks faced by the concessionaire. For example, for solid waste collection concessions not requiring heavy fixed investments, the periodicity may be relatively short (three to five years, for example), whereas longer periods may be desirable for power or water distribution concessions. In most countries, rebidding coincides with the end of the project term, but in others a concession may be granted for a long period (say 99 years), with periodic rebidding (for instance, every 10 or 15 years). In the latter mechanism, which has been adopted in a few countries, the first rebidding occurs before the concessionaire has fully recouped its investments. As an incentive to the incumbent operator, some laws provide that the concessionaire may be given preference over other bidders in the award of subsequent concessions for the same activity. However, the concessionaire may have rights to compensation if it does not win the next bidding round, in which case all or part of the bidding proceeds may revert to the incumbent concessionaire. Requiring that the winning bidder should pay off the incumbent concessionaire for any property rights and for the investment not yet recovered reduces the longer-term risk faced by investors and lenders and provides them a valuable exit option (see paras. 39 and 40).

8. Notwithstanding the above, it is advisable not to exclude entirely the option to negotiate an extension of the concession period under certain specified circumstances. The duration of an infrastructure project is one of the main factors taken into account in the negotiation of financial arrangements and has a direct impact on the price of the services provided by the concessionaire. The parties may find that an extension of the project agreement (as a substitute for or combined with other compensation mechanisms) may be a useful option to deal with unexpected impediments or other changes of circumstances arising during the life of the project. Such circumstances may include any of the following: extension to compensate for project suspension or loss of profit due to the occurrence of impeding events (see chap. IV, "Construction and operation of infrastructure", paras. 131-139); extension to compensate for project suspension brought about by the contracting authority or other public authorities (see chap. IV, "Construction and operation of infrastructure", paras. 140 and 141); or extension to allow the concessionaire to recover the cost of additional work required to be done on the facility and which the concessionaire would not be able to recover during the normal term of the project agreement without unreasonable tariff increases (see chap. IV, "Construction and operation of infrastructure", paras. 73-76). For purposes of transparency and accountability, in some countries the extension of the concession period is subject to a global cumulative limit or requires the approval of a specially designated public authority.

D. Termination

9. The grounds for termination of the project agreement before the expiry of its term and the consequences of any such termination are often dealt with in domestic legislation. Usually the law authorizes the parties to terminate the project agreement following the occurrence of certain types of events. The main interest of all parties involved in a privately financed infrastructure project is to ensure the satisfactory completion of the facility and the continuous and orderly provision of the relevant public service. Given the serious consequences of termination, as provision of the service may be interrupted or even discontinued, termination should under most circumstances be regarded as a measure of last resort. The conditions for the exercise of this right by either party should be carefully considered. While they may not need to be identical, it is generally desirable to achieve a broadly equitable balance of rights and conditions regarding termination for both parties.

10. In addition to identifying the circumstances or types of events that may give rise to a termination right, it is advisable for the parties to consider appropriate procedures to establish whether there are valid grounds for terminating the project agreement. Of particular importance is the question whether the project agreement may be unilaterally terminated or whether termination requires a decision by a judicial or other dispute settlement body.

11. The concessionaire is usually not allowed to terminate the project agreement without cause and in some legal systems termination by the concessionaire even in the event of breach by the contracting authority requires a final judicial decision. However, in some countries, pursuant to rules applicable to contracts with government entities, such a right may be exercised by public authorities, subject to payment of compensation to the concessionaire. In other countries, however, an exception is made in the case of public service concessions, whose contractual nature is found to be incompatible with unilateral termination rights. Lastly, some legal systems do not recognize unilateral termination rights for public authorities. However, project promoters and lenders would be concerned about the risk of premature or unjustified termination by the contracting authority, even where a decision to terminate might be subject to review through the dispute settlement mechanism. It should also be noted that giving the contracting authority the unilateral right to terminate the project agreement would not be an adequate substitute for well-designed contractual mechanisms of performance monitoring or for appropriate guarantees of performance (see chap. IV, "Construction and operation of infrastructure", paras. 80-97 and 108-120).

12. Provisions concerning termination should therefore be brought into line with the remedies for breach provided in the project agreement. In particular, it is useful to distinguish the conditions for termination from those for step-in by the contracting authority (see chap. IV, "Construction and operation of infrastructure", paras. 143-146). It is also important to consider the contracting authority's termination rights against the background of the financing agreements negotiated by the concessionaire with its lenders. In most cases, events that may lead to the termination of the project agreement would also constitute events of default under the loan agreements, with the consequence that the entire outstanding debt of the concessionaire may fall due immediately. It would thus be useful to attempt to avoid the risk of termination by allowing the lenders to propose another concessionaire when termination of the project agreement with the original concessionaire appears imminent (see chap. IV, "Construction and operation of infrastructure", paras. 108-120).

13. In the light of the above, it is generally advisable to provide that the termination of the project agreement in most cases require a final finding by the dispute settlement body provided in the agreement. Such a requirement would reduce concerns about premature or unjustified recourse to termination. At the same time, it would not preclude the taking of appropriate

measures to ensure the continuity of the service, pending the final decision of the dispute settlement body, as long as contractual remedies for breach, such as step-in rights for the contracting authority and the lenders, are provided in the project agreement. In countries where such a requirement would not be consistent with general principles of administrative law applicable to government contracts, it might be important to ensure, at least, that the contracting authority's right to terminate the project agreement should be without prejudice to the concessionaire's right to seek subsequent judicial review of the contracting authority's decision to terminate.

1. Termination by the contracting authority

14. The contracting authority's termination rights usually relate to three categories of circumstances: serious breach by the concessionaire; insolvency or bankruptcy of the concessionaire; and termination for reasons of public interest.

(a) Serious breach by the concessionaire

15. The contracting authority has the duty to ensure that public services are provided in accordance with applicable laws, regulations and contractual provisions. Thus, a number of domestic laws expressly recognize the contracting authority's right to terminate the project agreement in the event of breach by the concessionaire. Because of the disruptive effects of termination and in the interest of preserving the continuity of the service, it is not advisable to regard termination as a sanction for each and any instance of unsatisfactory performance by the concessionaire. On the contrary, it is generally advisable to resort to the extreme remedy of termination only in cases of "particularly serious" or "repeated" failures to perform, especially when it can no longer be reasonably expected that the concessionaire will be able or willing to perform under the project agreement. Many legal systems use specific technical expressions to refer to situations where the degree of breach by one contracting party is of such a nature that the other party may terminate their contractual relation before the expiry of its term (for example, "fundamental breach", "material breach" or similar expressions). Such situations are referred to in the *Guide* as "serious breach".

16. Circumscribing the possibility of termination to cases of serious breach may give assurance to lenders and project promoters that they will be protected against unreasonable or premature decisions by the contracting authority. The law may generally provide for the contracting authority's right to terminate the project agreement upon serious breach by the concessionaire and leave it for the project agreement to define further the notion of serious breach and, as appropriate, provide illustrative examples of it. From a practical point of view, it is not advisable to attempt, by statute or in the project agreement, to provide a list of the events that justify termination.

17. As a general rule, it is desirable that the concessionaire be granted an additional period of time to fulfil its obligations and to avert the consequences of its breach prior to the contracting authority's resorting to remedies. For example, the concessionaire should be given notice specifying the nature of the relevant circumstances and requiring it to rectify them within a certain period. The possibility might also be given for the lenders and sureties, as the case may be, to avert the consequences of the concessionaire's breach, for instance by temporarily engaging a third party to cure the consequences of breach by the concessionaire, in accordance with the terms of the performance bonds provided to the contracting authority or the terms of a direct agreement between the lenders and the contracting authority (see chap. IV, "Construction and operation of infrastructure", paras. 108-120 and 147-150). The project agreement may also provide that, if the circumstances are not rectified before the expiry of the

relevant period, the contracting authority may then terminate the project agreement, subject to first notifying the lenders and giving them an opportunity within a certain period to exercise any right of substitution that the lenders might have in accordance with a direct agreement between them and the contracting authority. However, reasonable deadlines need to be set, since the contracting authority cannot be expected to bear indefinitely the continuing cost of a situation of breach of the project agreement by the concessionaire. Furthermore, the procedures should be without prejudice to the contracting authority's right to step in to avert the risk of disruption of service by the concessionaire (see chap. IV, "Construction and operation of infrastructure", paras. 145 and 146).

(i) Serious breach before the beginning of construction

18. The concessionaire typically needs to accomplish a series of steps prior to undertaking construction works. Some of these requirements may even constitute conditions precedent to the entry into force of the project agreement. Examples of events that often justify the withdrawal of the concession award at an early stage include the following:

(a) Failure to secure the required financial means, to sign the project agreement or to establish the project company within the established deadline;

(b) Failure to obtain licences or permits required for pursuing the activity that is the object of the concession;

(c) Failure to undertake the construction of the facility, to commence development of the project or to submit the plans and designs required within a set period of time from the award of the concession.

19. Termination should in principle be reserved for situations where the contracting authority may no longer reasonably expect that the selected concessionaire will take the necessary measures to commence execution of the project. In that connection, it is important for the contracting authority to take into account any circumstances that may excuse the concessionaire's delay in fulfilling its obligations. Furthermore, the concessionaire should not suffer the consequences of inaction or error on the part of the contracting authority or other public authorities. For instance, the termination of the project agreement would not normally be justified if the concessionaire's failure to obtain government licences and permits within the agreed schedule was not attributable to the concessionaire's own fault.

(ii) Serious breach during the construction phase

20. Examples of events that may justify the termination of the project agreement during the construction phase include the following:

(a) Failure to observe building regulations, specifications or minimum design and performance standards and non-excusable failure to complete work within the agreed schedule;

(b) Failure to provide or renew the required guarantees in the agreed terms;

(c) Violation of essential statutory or contractual obligations.

21. Termination should be commensurate with the degree of breach by the concessionaire and the consequences of breach for the contracting authority. For instance, the contracting authority may have a legitimate interest in specifying a date when the construction must be completed and may therefore be justified in regarding a delay in completion as an event of breach and hence a ground for termination. However, delay alone, in particular if it is not excessive in relation to the specifications of the project agreement, might not be sufficient reason for termination when the contracting authority is otherwise satisfied of the

concessionaire's ability to complete the construction in accordance with the required quality standards and its commitment to doing so.

(iii) Serious breach during the operational phase

22. Examples of particular instances of breach that typically justify the termination of the concession during the operational phase include any of the following:

(a) Serious failure to provide services in accordance with the statutory and contractual standards of quality, including disregard of price control measures;

(b) Non-excusable suspension or interruption of the provision of the service without prior consent from the contracting authority;

(c) Serious failure by the concessionaire to maintain the facility, its equipment and appurtenances in accordance with the agreed standards of quality or non-excusable delay in carrying out maintenance works in accordance with the agreed plans, schedules and timetables;

(d) Failure to comply with sanctions imposed by the contracting authority or the regulatory agency, as appropriate, for infringements of the concessionaire's duties.

23. For the purpose of enhancing transparency and integrity in governmental matters, the laws of some countries also provide for the termination of project agreements if the concessionaire is guilty of tax fraud or other types of fraudulent acts, or if its agents or employees are involved in bribery of public officials and other corrupt practices (see also chap. VII, "Other relevant areas of law", paras. 50-52). The later considerations underscore the importance of designing effective mechanisms to combat corruption and bribery and to afford the concessionaire the opportunity to file complaints against demands for illegal payments or unlawful threats by officials of the host country.

(b) Insolvency of the concessionaire

24. Infrastructure services typically need to be provided continuously and for that reason most domestic laws stipulate that the agreement may be terminated if the concessionaire is declared insolvent or bankrupt. In order to ensure the continuity of the service, the assets and property required to be handed over to the contracting authority may be excluded from the insolvency proceedings and the law may require prior governmental approval for any act of disposition by a liquidator or insolvency administrator of any categories of assets owned by the concessionaire.

25. In legal systems that allow the establishment of security interests over the concession itself (see chap. IV, "Construction and operation of infrastructure", para. 57), the law usually provides that the contracting authority may, in consultation with the secured creditors, appoint a temporary administrator so as to ensure the continued provision of the relevant service, until the secured creditors admitted to the insolvency proceedings decide, upon the recommendation of the insolvency administrator, whether the activity should be pursued or whether the right to exploit the concession should be put to a bidding process.

(c) Termination for reasons of public interest

26. In the contracting practice of some countries, public authorities procuring construction works traditionally retain the right to terminate the construction contract for reasons of public interest (that is, without having to provide any justification other than that the termination is in the Government's interest). In some common law jurisdictions, that right, which is sometimes referred to as "termination for convenience", can only be exercised if expressly provided for in

a statute or in the relevant contract. Several legal systems belonging to the civil law tradition also recognize a similar power of public authorities to terminate contracts for reasons of public interest or "general interest". In some countries, such a right may be implied in the Government's contracting power, even in the absence of an explicit statutory or contractual provision to that effect. The Government's right to terminate for reasons of public interest, in those legal systems which recognize it, is regarded as essential in order to preserve the Government's unfettered ability to exercise its functions affecting the public good.

27. Nevertheless, the conditions for the exercise of this right, and the consequences of doing so, should be carefully considered. The authority to determine what constitutes public interest may lie within the Government's discretion, so that the contracting authority's decision to terminate the project agreement could only be challenged under specific circumstances (for instance, improper motive, "*détournement de pouvoir*"). However, a general and unqualified right to terminate the project agreement for reasons of public interest may represent an imponderable risk that neither the concessionaire nor the lenders may be ready to accept without sufficient guarantees that they will receive prompt compensation for the loss sustained. The possibility of termination for reasons of public interest, where contemplated, should therefore be made known to prospective investors on the earliest possible occasion and should be expressly mentioned in the draft project agreement circulated with the request for proposals (see chap. III, "Selection of the concessionaire", para. 67). The compensation due for termination for reasons of public interest may, in practice, cover items that are taken into account when calculating the compensation that is due for termination for serious breach by the contracting authority (see para. 42). Furthermore, it is generally advisable to limit the exercise of the right to terminate the project agreement to situations where such termination is needed for a compelling reason of public interest, which should be restrictively interpreted (for example, where major subsequent changes in governmental plans and policies require the integration of a project into a larger network or where changes in the contracting authority's plans require major project revisions that substantially affect the original design or the project's commercial feasibility under private operation). In particular, it is not advisable to regard the right of termination for reasons of public interest as a substitute for other contractual remedies in case of dissatisfaction with the concessionaire's performance (see chap. IV, "Construction and operation of infrastructure", paras. 140-150).

2. Termination by the concessionaire

28. While the contracting authority in some legal systems may retain an unqualified right to terminate the project agreement, the grounds for termination by the concessionaire are usually limited to serious breach by the contracting authority or other exceptional situations and do not normally include a general right to terminate the project agreement at will. Moreover, some legal systems do not recognize the concessionaire's right to terminate the project agreement unilaterally, but only the right to request a third party, such as the competent court, to declare the termination of the project agreement.

(a) Serious breach by the contracting authority

29. Generally, the concessionaire's right to terminate the project agreement is limited to situations where the contracting authority is found to be in breach of a substantial part of its obligations (such as failure to make agreed payments to the concessionaire or failure to issue licences required for the operation of the facility for reasons other than the concessionaire's own fault). In those legal systems where the contracting authority has the right to request modifications in the project, the concessionaire may have the right to terminate the project

agreement if the contracting authority alters or modifies the original project in such a fashion as to cause a substantial increase in the amount of investment required and the parties fail to agree on the appropriate amount of compensation (see chap. IV, "Construction and operation of infrastructure", paras. 73-76).

30. In addition to serious breach by the contracting authority itself, it may be equitable to authorize termination by the concessionaire should the latter be rendered unable to provide the service as a result of acts of public authorities other than the contracting authority, such as failure to provide certain measures of support required for the execution of the project agreement (see chap. II, "Project risks and government support", paras. 35-60).

31. Although termination by the concessionaire may not always require a final finding by a judicial or other dispute settlement body, there may be limits to the remedies available to the concessionaire in the event of breach by the contracting authority. Pursuant to a rule of law followed in many legal systems, a party to a contract may withhold performance of its obligations in the event of breach by the other party of a substantial part of its obligations. However, in some legal systems that rule does not apply to government contracts and the law provides instead that government contractors are not excused from performing solely on the ground of breach by the contracting authority unless and until the contract is rescinded by a judicial or arbitral decision.

32. Limitations on the concessionaire's right to withhold performance are typically intended to ensure the continuity of public services (see chap. IV, "Construction and operation of infrastructure", paras. 86 and 87). Nevertheless, it should be noted that while the contracting authority may mitigate the consequences of breach by the concessionaire by using its right to step in, the concessionaire does not usually have a comparable remedy. In the event of serious breach by the contracting authority, the concessionaire may sustain considerable or even irreparable damage, depending on the time required to obtain a final decision releasing the concessionaire from its obligations under the project agreement. These circumstances underscore the importance of government guarantees in respect of obligations assumed by contracting authorities (see chap. II, "Project risks and government support", paras. 45-50) and the need for allowing the parties the choice of expeditious and effective dispute settlement mechanisms (see chap. VI, "Settlement of disputes", paras. 3-42).

(b) Changes in conditions

33. Domestic laws often allow the concessionaire to terminate the project agreement if the concessionaire's performance has been rendered substantially more onerous by the occurrence of an unforeseen change in conditions and the parties have failed to agree on an appropriate revision to adapt the project agreement to the changed conditions (see chap. IV, "Construction and operation of infrastructure", paras. 126-130).

3. Termination by either party

(a) Impediment of performance

34. Some laws provide that the parties may terminate the project agreement if the performance of their obligations is rendered permanently impossible as a result of a circumstance defined in the project agreement as an exempting impediment (see chap. IV, "Construction and operation of infrastructure", paras. 132-139). In that connection, it is advisable to provide in the project agreement that if the exempting impediment persists for a certain period or if the cumulative duration of two or more exempting impediments exceeds a certain time, the agreement may be

terminated by either party. If the execution of the project is rendered impossible on legal grounds, because of changes in legislation or as a result of judicial decisions affecting the validity of the project agreement, for instance, such a termination right might not require any period of time to elapse and might be exercised immediately upon the change of legislation or other legal obstacle becoming effective.

(b) Mutual consent

35. Some domestic laws authorize the parties to terminate the project agreement by mutual consent, usually subject to the approval of a higher authority. Legislative power to this effect may be needed by the contracting authority in legal systems where the termination by mutual consent might amount to a discontinuation of the public service for which the contracting authority is responsible.

E. Consequences of expiry or termination of the project agreement

36. The concessionaire's right to operate the facility and to provide the relevant service typically finishes upon expiry of the project term or termination of the project agreement. Unless the infrastructure is to be permanently owned by the concessionaire, the expiry or termination of the project agreement often requires the transfer of assets to the contracting authority or to another concessionaire who undertakes to operate the facility. There may be important financial consequences that will need to be regulated in detail in the project agreement, in particular in the event of termination by either party. The parties will also need to agree on various wind-up measures to ensure the orderly transfer of the responsibility for operating the facility and providing the service.

1. Transfer of project-related assets

37. In most cases, the assets and property originally made available to the concessionaire and other goods related to the project are to revert to the contracting authority upon expiry or termination of the project agreement (see chap. IV, "Construction and operation of infrastructure", paras. 23-29). In a typical "build-operate-transfer" project, the concessionaire would also be obliged to transfer to the contracting authority the physical infrastructure and other project-related assets upon expiry or termination of the project agreement. The assets required to be transferred to the contracting authority often include intangible assets, such as outstanding receivables and other rights existing at the time of transfer. Depending on the project, the assets to be transferred may include specific technology or know-how (see paras. 51-55). It should be noted that in some projects the assets are transferred directly from the concessionaire to another concessionaire who succeeds it in the provision of the service.

(a) Transfer of assets to the contracting authority

38. Different arrangements may be needed, depending on the type of asset to be transferred (see chap. IV, "Construction and operation of infrastructure", para. 28):

(a) *Assets that must be transferred to the contracting authority*. In the legal tradition of some countries, at the end of the project term, the concessionaire is required to transfer such assets free of any liens and encumbrances and at no cost to the contracting authority, except for compensation for improvements made to, or modernization of, the property for the purpose of ensuring the continuity of the service the cost of which has not yet been recovered by the concessionaire. In practice, such a rule presupposes the negotiation of a concession period

sufficiently long and a level of revenue high enough for the concessionaire to amortize fully its investment and to repay its debts in full. Other laws allow for more flexibility by authorizing the contracting authority to compensate the concessionaire for the residual value, if any, of assets built by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option*. If the contracting authority decides to exercise its option to purchase those assets, the concessionaire is normally entitled to compensation corresponding to their fair market value at the time. However, if those assets were expected to be fully amortized (that is, if the concessionaire's financing arrangements do not envisage any expectation of residual value of the assets), then the price paid might be only nominal. In the contracting practice of some countries, it is usual for contracting authorities to be granted some security interest in such assets as a guarantee for their effective transfer;

(c) *Assets that remain the private property of the concessionaire*. Typically these assets may be freely removed or disposed of by the concessionaire.

(b) Transfer of assets to a new concessionaire

39. As indicated earlier, the contracting authority may wish to rebid the concession at the end of the project agreement, rather than to operate the facility itself (see para. 3). For that purpose, it may be useful for the law to require the concessionaire to make the assets available to a new concessionaire. In order to ensure an orderly transition and continuity of the service, the concessionaire should be required to cooperate with the new concessionaire in the handover. The transfer of assets between the concessionaires may require that some compensation be paid to the incumbent concessionaire, depending on whether or not the assets have been amortized.

40. One important element to consider in this connection is the structure of the financial proposal formulated by the concessionaire during the selection process (see also chap. IV, "Construction and operation of infrastructure", para. 27). In public infrastructure projects, one of the basic assumptions of the bidders' financial proposal is that all assets required to be built or acquired for the project will be fully amortized (that is, their cost will be recovered in full) in the life of the project. Thus, the financial proposals will not normally include an expectation of residual value for the assets at the end of the project period. In such cases, there may not be a prima facie reason for requiring a successor concessionaire to pay any compensation to the original concessionaire, which may be required to make all assets available to its successor at no cost or only for a nominal consideration. Indeed, if the concessionaire has achieved its expected return, a transfer payment from a successor concessionaire would be an additional cost that would ultimately have to be remunerated by the prices charged by the successor under the second agreement. However, if the tariff level contemplated in the concessionaire's original proposal was based on the assumption of some residual value of the assets at the end of the project period or if the financial proposal assumed significant revenue from third parties, the concessionaire might be entitled to compensation for assets handed over to a successor concessionaire.

(c) Condition of assets at the time of transfer

41. Where assets are handed over to the contracting authority or transferred directly to a new concessionaire upon the expiry of the concession period, the concessionaire is typically obligated to transfer them, free of liens or encumbrances, and in such condition as would be necessary for normal functioning of the infrastructure facility, taking into account the needs of

the service. The contracting authority's right to receive those assets in such operating condition is complemented in some laws by the obligation imposed upon the concessionaire to keep and transfer the project in such proper condition as prudent maintenance requires and to provide some sort of guarantee to that effect (see chap. IV, "Construction and operation of infrastructure", para. 118). Where the contracting authority requires the assets to be returned in a prescribed condition, the required conditions should be reasonable. While it may be reasonable for the contracting authority to require that the assets have some defined period of residual life, it would not be reasonable to expect them to be as new. Furthermore, these requirements may not be applicable in the event of termination of the project agreement, in particular termination prior to successful completion of the construction phase.

42. It is advisable to devise procedures for ascertaining the condition of the assets that should be transferred to the contracting authority. It may be useful, for example, to establish a committee comprised of representatives of both the contracting authority and the concessionaire to establish whether the facilities are in the prescribed condition and conform to the relevant requirements set forth in the project agreement. The project agreement may also provide for the appointment and terms of reference of such a committee, which may be given authority to request reasonable measures by the concessionaire to repair or eliminate any defects and deficiencies found in the facilities. It may be advisable to provide for a special inspection to take place one year prior to the termination of the concession, following which the contracting authority may require additional maintenance measures by the concessionaire so as to ensure that the goods are in proper condition at the time of the transfer. The contracting authority may wish to require that the concessionaire provide special guarantees for the satisfactory handover of the facilities (see chap. IV, "Construction and operation of infrastructure", para. 118). The contracting authority might draw on such guarantees to pay the repair cost of damaged assets or property.

2. Financial arrangements upon termination

43. Termination of the project agreement may occur before the concessionaire has been able to recover its investment, repay its debts and yield the expected profit, which may cause significant loss to the concessionaire. Loss may also be sustained by the contracting authority, which may need to make additional investment or incur considerable expense in order, for instance, to ensure the completion of the facility or the continued provision of the relevant services. In view of these circumstances, project agreements typically contain extensive provisions dealing with the financial rights and obligations of the parties upon termination. The usual standards of compensation typically vary according to the various grounds for termination. Nevertheless, the following factors are usually taken into account in compensation arrangements:

(a) *Outstanding debt, equity investment and anticipated profit.* Project termination is typically included among the events of default in the concessionaire's loan agreements. Since loan agreements usually include a so-called "acceleration clause", whereby the entire debt may become due upon the occurrence of an event of default, the immediate loss sustained by the concessionaire upon termination of the project agreement may include the amount of debt then outstanding. Whether and to what extent such a loss might be compensated for by the contracting authority usually depends on the grounds for terminating the project agreement. Partial compensation may be limited to an amount corresponding to the value of works satisfactorily performed by the concessionaire, whereas full compensation would cover the entire outstanding debt. Another category of loss that is sometimes taken into account in compensation arrangements refers to loss of equity investment by the project promoters, to the

extent that such an investment has not yet been recovered at the time of termination. Lastly, termination also deprives the concessionaire of future profits that the facility may generate. Although lost profits are not usually regarded as actual damage, in exceptional circumstances, such as wrongful termination by the contracting authority, the current value of expected future profit may be included in the compensation due to the concessionaire;

(b) *Degree of completion, residual value and amortization of assets.* Contractual compensation schemes for various termination grounds typically include compensation commensurate with the degree of completion of the works at the time of termination. The value of the works is usually determined on the basis of the investment required for construction (in particular if the termination takes place during the construction phase), the replacement cost or the "residual" value of the facility. The residual value means the market value of the infrastructure at the time of termination. Market value may be difficult to determine or even inexistent for certain types of physical infrastructure (such as bridges or roads) or for facilities whose operational life is close to expiry. Sometimes the residual value may be estimated taking into account the expected usefulness of the facility for the contracting authority. However, difficulties may be found in establishing the value of unfinished works, in particular if the amount of the investment still required by the contracting authority to render the facility operational would exceed the amount actually invested by the concessionaire. In any event, full payment of residual value seldom takes place, in particular where the project's revenue constitutes the sole remuneration for the concessionaire's investment. Thus, instead of full compensation for the facility's value, the concessionaire often receives compensation only for the residual value of assets that have not yet been fully amortized at the time of termination.

(a) Termination due to breach by the concessionaire

44. The concessionaire is not usually entitled to damages in the event of termination due to its own breach. In some cases the concessionaire may be under an obligation to pay damages to the contracting authority, although, in practice, a defaulting concessionaire whose debts are declared due by its creditors would seldom have sufficient financial means left for actual payment of such damages.

45. It should be noted that termination due to breach, even where it is regarded as a sanction for serious performance failures, should not result in the unjust enrichment of either party. Thus, termination does not necessarily entail a right for the contracting authority to take over assets without making any payment to the concessionaire. An equitable solution for dealing with this issue may be to distinguish between the different types of asset, according to the arrangements envisaged for them in the project agreement (see para. 38):

(a) *Assets that must be transferred to the contracting authority.* Where the project agreement requires the automatic transfer of project assets to the contracting authority at the end of the project agreement, termination on breach does not usually entail the payment of compensation to the concessionaire for those assets, except for the residual value of work satisfactorily performed, to the extent that it has not yet been amortized by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option.* Financial compensation may be adequate in cases where the contracting authority has an option to buy the assets at market value on expiry of the project agreement or the right to require that such an option be given to the winner of a new project award. However, it may be legitimate to envisage a financial compensation that is less than the full value of the assets so as to stimulate performance by the concessionaire. By the same token, such compensation may not need to cover the full cost of repaying the concessionaire's outstanding debt. It is advisable to set forth

the details of the formula for financial compensation in the project agreement (that is, whether it covers the break-up value of the asset or the lesser of the outstanding debt and the alternative use value);

(c) *Assets that remain the private property of the concessionaire.* Assets in the concessionaire's private property that do not fall under (a) or (b) above may usually be removed and disposed of by the concessionaire, so that the need for compensation arrangements seldom arises. However, a different situation may arise in the case of fully privatized projects, where all assets, including those essential for the provision of the services, are owned by the concessionaire. In such cases, in order to ensure the continuity of the services, the contracting authority may find it necessary to take over the assets, even though not contemplated in the project agreement. In such cases, it would be equitable to compensate the concessionaire for the fair market value of the assets. The project agreement may, however, provide that the compensation should be reduced by the costs incurred by the contracting authority in operating the facility or engaging another operator.

(b) Termination due to breach by the contracting authority

46. The concessionaire is usually entitled to full compensation for loss sustained as a result of termination on grounds attributable to the contracting authority. The compensation due to the concessionaire usually includes compensation for the value of the works and installations, to the extent they have not already been amortized, as well as for the loss caused to the concessionaire, including lost profits, which are usually calculated on the basis of the concessionaire's revenue during previous financial years, when termination occurs during the operational phase, or are based on a projection of the expected benefit during the duration originally envisaged. The concessionaire may be entitled to full compensation of debt and equity, including debt service and lost profits.

(c) Termination on other grounds

47. When considering compensation arrangements for termination due to circumstances unrelated to breach by either party, it may be useful to distinguish exempting impediments from termination declared by the contracting authority for reasons such as public interest or other similar reasons.

(i) Termination due to exempting impediments

48. By definition, exempting impediments are events beyond the parties' control and, as a general rule, termination under such circumstances might not give rise to claims for damages by either party. However, there may be circumstances where it might be equitable to provide for some compensation to the concessionaire, such as fair compensation for works already completed, in particular where, because of the specialized nature of the assets, they cannot be removed by the concessionaire or meaningfully used by it, but may be effectively used by the contracting authority for the purpose of providing the relevant service (a bridge, for instance). However, since termination in such cases cannot be attributed to the contracting authority, the compensation due to the concessionaire may not necessarily need to be "full" compensation (that is, repayment of debt, equity and lost profits).

(ii) Termination for convenience

49. Where the project agreement recognizes the contracting authority's right to terminate for its convenience, the compensation payable to the concessionaire usually covers compensation

for the same items included in compensation payable upon termination for breach by the contracting authority (see para. 46), although not necessarily to the full extent. In order to establish the equitable amount of compensation due to the concessionaire, it may be useful to distinguish between termination for convenience during the construction phase and termination for convenience during the operational phase:

(a) *Termination for convenience during the construction phase*. If the project agreement is terminated during the construction phase, the compensation arrangements may be similar to those which are followed in connection with large construction contracts that allow for termination for convenience. In those cases, the contractor is usually entitled to the portion of the price that is attributable to the construction satisfactorily performed, as well as for expenses and losses incurred by the contractor arising from the termination. However, since the contracting authority does not normally pay a price for the construction work carried out by the concessionaire, the main criterion for calculating compensation would typically be the total investment effectively made by the concessionaire up to the time of termination, including all sums actually disbursed under the loan facilities extended by the lenders to the concessionaire for the purpose of carrying out construction under the project agreement, and expenses related to the cancellation of loan agreements. One additional question is whether and to what extent the concessionaire may be entitled to recover lost profit for the portion of the contract that has been terminated for convenience. On the one hand, the concessionaire might have foregone other business opportunities in anticipation of completing the project and operating the facility through the anticipated duration of the concession. On the other hand, an obligation of the contracting authority to compensate the concessionaire for its lost profit might make it financially prohibitive for the contracting authority to exercise its right of termination for convenience. One approach may be for the project agreement to establish a scale of payments to be made by the contracting authority as compensation for lost profits and the amount of the payments depending upon the stage of the construction that has been completed when the project agreement is terminated for convenience;

(b) *Termination for convenience during the operational phase*. As regards the construction work satisfactorily completed by the concessionaire, the compensation arrangements may be the same as for termination for convenience during the construction phase. However, equitable compensation for termination for convenience during the operational phase might require fair compensation for lost profits. The higher standard of compensation in this case may be justified by the fact that, unlike termination during the construction phase, when the contracting authority might need to undertake to complete the work at its own expense, upon termination during the operational phase the contracting authority might be able to receive a completed facility capable of being operated profitably. Compensation for lost profits is often calculated on the basis of the concessionaire's revenue during a certain number of previous financial years, but in some cases other elements, such as the anticipated profit on the basis of the agreed tariffs, may need to be taken into account. This is so because in some infrastructure projects such as toll roads and similar projects, which are characterized by high financial costs and relatively low income at the early stages of operation, termination may occur before the project has a history of profitability.

3. Wind-up and transitional measures

50. Where the facility is transferred to the contracting authority at the end of the concession period, the parties may need to make a series of arrangements in order to ensure that the contracting authority will be able to operate the facility at the prescribed standards of efficiency and safety. The project agreement may provide for the concessionaire's obligation to transfer

certain technology or know-how required to operate the infrastructure facility. The project agreement may also provide for the continuation, for a certain transitional period, of certain obligations of the concessionaire in respect of the operation and maintenance of the facility. It may further include an obligation, on the part of the concessionaire, to supply or facilitate the supply of spare parts that may be needed by the contracting authority to carry out repairs in the facility. It should be noted, however, that the concessionaire might not be in a position to undertake itself some of the transitional measures referred to below, since in most cases the concessionaire would have been established for the sole purpose of carrying out the project and would need to procure the relevant technology or spare parts from third parties.

(a) Transfer of technology

51. In some cases, the facility transferred to the contracting authority will embody various technological processes necessary for the generation of certain goods, such as electricity or potable water, or the provision of the relevant services, such as telephone services. The contracting authority will often wish to acquire a knowledge of those processes and their application. The contracting authority will also wish to acquire the technical information and skills necessary for the operation and maintenance of the facility. Even where the contracting authority has the basic capability to undertake certain elements of the operation and maintenance (for example, building or civil engineering), the contracting authority may need to acquire a knowledge of special technical processes necessary to effect the operation in a manner appropriate to the facility in question. The communication to the contracting authority of that knowledge, information and skills is often referred to as the "transfer of technology". Obligations concerning the transfer of technology cannot be unilaterally imposed on the concessionaire and, in practice, these matters are the subject of extensive negotiations between the parties concerned. While the host country has a legitimate interest in gaining access to the technology needed to operate the facility, due account should be taken of the commercial interests and business strategies of the private investors.

52. Differing contractual arrangements can be adopted for the transfer of technology and the performance of the other obligations necessary to construct and operate the facility. The transfer of technology itself may occur in different ways, for example, through the licensing of industrial property, through the creation of a joint venture between the parties or the supply of confidential know-how. The *Guide* does not attempt to deal comprehensively with contract negotiation and drafting relating to the licensing of industrial property or the supply of know-how, as this subject has already been dealt with in detail in publications issued by other United Nations bodies.[1] The following paragraphs merely note certain major issues concerning the communication of skills necessary for the operation and maintenance of the facility through the training of the contracting authority's personnel or through documentation.

53. The most important method of conveying to the contracting authority the technical information and skills necessary for the proper operation and maintenance of the works is the training of the contracting authority's personnel. In order to enable the contracting authority to decide on its training requirements, in the request for proposals or during the contract negotiations the contracting authority might request the concessionaire to supply the contracting authority with an organizational chart showing the personnel requirements for the operation and maintenance of the works, including the basic technical and other qualifications the personnel must possess. Such a statement of requirements should be sufficiently detailed to enable the contracting authority to determine the extent of training required in relation to the personnel available to it. The concessionaire will often have the capability to provide the

training. In some cases, however, the training may be given more effectively by a consulting engineer or through an institution specializing in training.

54. Technical information and skills necessary for the proper operation and maintenance of the facility may also be conveyed through the supply of technical documentation. The documentation to be supplied may consist of plans, drawings, formulae, manuals of operation and maintenance and safety instructions. It may be advisable to list in the project agreement the documents to be supplied. The concessionaire may be required to supply documents that are comprehensive and clearly drafted and are in a specified language. It may be advisable to obligate the concessionaire, at the request of the contracting authority, to give demonstrations of procedures described in the documentation if the procedures cannot be understood without demonstrations.

55. The points in time when the documentation is to be supplied may be specified. The project agreement may provide that the supply of all documentation is to be completed by the time fixed in the contract for completion of the construction. The parties may also wish to provide that transfer of the facility is not to be considered completed unless all documentation relating to the operation of the works and required under the contract to be delivered prior to the completion has been supplied. It may be advisable to provide that some documentation, such as operating manuals, is to be supplied during the course of construction, as such documentation may enable the contracting authority's personnel or engineer to obtain an understanding of the working of machinery or equipment while it is being erected.

(b) Assistance in connection with operation and maintenance of the facility after its transfer

56. The degree of assistance from the concessionaire needed by the contracting authority with regard to the supply of spare parts and services will depend on the technology and skilled personnel available to the contracting authority. If the contracting authority lacks personnel sufficiently skilled for the technical operation of the facility, it may wish to obtain the concessionaire's assistance in operating the facility, at least for an initial period. The contracting authority may, in some cases, wish the concessionaire to provide the personnel to occupy many of the technical posts in the facility, while in other cases the contracting authority may wish the concessionaire only to provide technical experts to collaborate in an advisory capacity with the contracting authority's personnel in the performance of a few highly specialized operations.

57. In order to assist the contracting authority in operating and maintaining the facility, the project agreement may obligate the concessionaire to submit, prior to the transfer of the facility, an operation and maintenance programme designed to keep the facility operating over its remaining lifetime at the level of efficiency required under the project agreement. An operation and maintenance programme would include matters such as an organizational chart showing the key personnel required for the technical operation of the facility and the functions to be discharged by each person; periodic inspection of the facility; lubrication, cleaning and adjustment; and replacement of defective or worn-out parts. Maintenance may also include operations of an organizational character, such as establishing a maintenance schedule or maintenance records. The concessionaire may also be required by the contracting authority to supply operation and maintenance manuals setting out appropriate operation and maintenance procedures. Those manuals should be in a format and language readily understood by the contracting authority's personnel.

58. An effective means of training the contracting authority's personnel in operation and maintenance procedures may be to provide in the project agreement that the personnel of the

contracting authority are to be associated with the personnel of the concessionaire in carrying out the operation and maintenance for a certain time prior to or beyond the transfer of the facility. The positions to be occupied by the personnel employed by the contracting authority can then be identified and their qualifications and experience specified. In order to avoid friction and inefficiency, it is desirable that any authority to be exercised by the personnel of each party over the personnel of the other during the relevant period be clearly described.

(c) Supplies of spare parts

59. In projects that provide for the transfer of the facility to the contracting authority, the contracting authority will have to obtain spare parts to replace those which are worn out or damaged and to maintain, repair and operate the facility. Spare parts may not be available locally and the contracting authority may have to depend on the concessionaire to supply them. The planning of the parties with respect to the supply of spare parts and services after the transfer of the facility would be greatly facilitated if the parties were to anticipate and provide in the project agreement for the needs of the contracting authority in that regard. However, given the long duration of most infrastructure projects, it may be difficult for the parties to anticipate and provide in the project agreement for the needs of the contracting authority after the transfer of the facility.

60. A possible approach may be for the parties to enter into a separate contract regulating these matters.[2] Such a contract may be entered into closer in time to the transfer of the facility, when the contracting authority may have a clearer view of its requirements. If spare parts are manufactured not by the concessionaire but for the concessionaire by suppliers, the contracting authority may prefer to enter into contracts with those suppliers rather than to obtain them from the concessionaire or, alternatively, the contracting authority may wish to have the concessionaire procure them as the contracting authority's agent.

61. It is desirable for the contracting authority's personnel to develop the technical capacity to install the spare parts. For this purpose, the project agreement may obligate the concessionaire to supply the necessary instruction manuals, tools and equipment. The instruction manuals should be in a format and language readily understood by the contracting authority's personnel. The contract may also require the concessionaire to furnish "as built" drawings indicating how the various pieces of equipment interconnect and how access can be obtained to them to enable the spare parts to be installed and to enable maintenance and repairs to be carried out. In certain cases, it may be appropriate for the concessionaire to be required to train the contracting authority's personnel in the installation of spare parts.

(d) Repairs

62. It is in the contracting authority's interest to enter into contractual arrangements that will ensure that the facility will be repaired expeditiously in the event of a breakdown. In many cases, the concessionaire may be better qualified than a third person to effect repairs. In addition, if the project agreement prevents the contracting authority from disclosing to third persons the technology supplied by the concessionaire, this may limit the selection of third persons to effect repairs to those who provide assurances regarding non-disclosure of the concessionaire's technology that are acceptable to the concessionaire. On the other hand, if major items of equipment have been manufactured for the concessionaire by suppliers, the contracting authority may find it preferable to enter into independent contracts for repair with them. In defining the nature and duration of repair obligations imposed on the concessionaire, if any, it is advisable to do so clearly and to distinguish them from obligations assumed by the concessionaire under quality guarantees to remedy defects in the facility.

Notes

[1] The negotiation and drafting of contracts for the licensing of industrial property and the supply of know-how is dealt with in detail in World Intellectual Property Organization, *Licensing Guide for Developing Countries* (WIPO publication No. 620 (E), 1977). The main issues to be considered in negotiating and drafting such contracts are set forth in the *Guidelines for Evaluation of Transfer of Technology Agreements*, Development and Transfer of Technology Series, No. 12 (ID/233, 1979), and in the *Guide for Use in Drawing Up Contracts Relating to the International Transfer of Know-How in the Engineering Industry* (United Nations publication, Sales No. E.70.II.E.15). Another relevant publication is the *Handbook on the Acquisition of Technology by Developing Countries* (United Nations publication, Sales No. E.78.II.D.15). For a discussion of transfer of technology in the context of contracts for the construction of industrial works, see the *UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (United Nations publication, Sales No. E.87.V.10), chap. VI, "Transfer of technology".

[2] The Economic Commission for Europe has prepared a *Guide on Drawing Up International Contracts for Services Relating to Maintenance, Repair and Operation of Industrial and Other Works*, which may, *mutatis mutandis*, assist parties in drafting a separate contract or contracts dealing with maintenance and repair of the facility after its transfer to the contracting authority (ECE/TRADE/154).